

BEFORE THE STATE BOARD OF EQUALIZATION
OF THE STATE OF CALIFORNIA

In the Matter of the Appeal of)
BAY AREA FINANCIAL CORPORATION)

For Appellant: Charles E. Kunz
Certified Public Accountant

For Respondent: Charlotte A. Meisel
Counsel

O P I N I O N

This appeal is made pursuant to section 25666 of the Revenue and Taxation Code from the action of the Franchise Tax Board on the protest of Bay Area Financial Corporation against a proposed assessment of additional franchise tax in the amount of \$5,400 for the income year ended June 30, 1979.

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The sole issue presented in this appeal is whether respondent abused its statutory discretion by reducing the claimed additions to appellant's bad debt reserve for the year in question.

Appellant is a California corporation, incorporated in 1960, which employs the accrual method of accounting and which on its franchise tax returns uses the reserve method of accounting for its bad debts. In the income year ended June 30, 1979, appellant deducted **\$352,198.56** as an addition to its bad debt reserve.

When appellant began its business in 1960 as a consumer finance company, its business consisted almost exclusively of making loans secured by personal property. In 1978 appellant began making loans which were secured by real property. Accordingly, receivables secured by personal property decreased from **\$1,126,000** to \$525,200 during the year at issue while receivables on loans secured by **real property** increased to **\$10,151,560**. After 1978 the only loans advanced which were not secured by real property were those made to previous customers who had good payment records. At this time appellant **also** reduced its number of offices from five to one.

Respondent, in auditing appellant's return for the income year ended June 30, 1979, found that the addition of **\$352,198.56** to its bad debt reserve was arrived at by averaging its previous losses. Respondent's auditor further discovered that all actual losses to the date of audit had been from loans **secured by** personal property and that appellant's auditors, the firm of Deloitte, **Haskins** and Sells, had **reduced** the amount of reserve for bad debts by \$60,000 based on this information. **Respondent's** auditor then compared the prior three years and noted that the reserve additions reported on the audited financial statements were identical to those reported on the returns. **Only** for the income year ended June 30, 1979, had appellant reported a different sum for tax purposes. Mr. Thomas Shepard, a partner in the accounting firm of Deloitte, **Haskins** and Sells, explained to **respondent's** auditor, that the \$60,000 reduction in the bad debt reserve was made because the new loans were secured by real property which, based on his experience, resulted in very few losses and because appellant hired a new collector who would increase recoveries. Based on this information, respondent reduced the reserve addition by \$60,000. The denial of the **\$60,000** in bad debt deductions gave rise to this appeal.

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Appellant maintains that respondent's action in disallowing the additions was arbitrary and amounts to an abuse of discretion. In support of this position, appellant has stated that the accounting firm of Ernst and Whinney, which subsequently became appellant's auditors, reversed the \$60,000 adjustment made by the auditors of Deloitte, **Haskins** and Sells. It further contends that the actual write-offs in 1980 and 1981 exceeded by \$46,000 the reserve on the books as of June 30, 1979. **Finally**, appellant alleges that it should be deemed to be a "new business" so that it could use the experiences of other businesses of similar size and activity when computing a reasonable addition to the bad debt reserve.

Subdivision (a) of section 24348 of the Revenue and Taxation Code provides:

(a) There shall be allowed as a deduction debts which become worthless within the income year; or, in the discretion of the Franchise Tax Board, a reasonable addition to a reserve for bad debts.

As we have noted in previous opinions, respondent's determinations with respect to additions to a reserve for bad debts carry great weight because of the express discretion granted it by statute. When the Franchise Tax Board disallows an addition to a reserve for bad debts, the taxpayer must not only demonstrate that additions to the reserve were reasonable, but also must establish that respondent's actions in disallowing those additions were arbitrary and amounted to an abuse of discretion. (Roanoke Vending Exchange, Inc., 40 T.C. 735 (1963); Appeal of Brighton Sand and Gravel Company, Cal. St. Bd. of Equal., Aug. 19, 1981; Appeal of Vaughn F. and Betty F. Fisher, Cal. St. Bd. of Equal., Jan. 7, 1975.) Here, appellant has failed to show the requisite arbitrariness or capriciousness of **respondent's** determination.

A bad debt reserve is essentially an estimate of future losses which can reasonably be expected to result from debts outstanding at the close of the taxable year. (Valmont Industries, Inc., 73 T.C. 1059 (1980).) Under the reserve method of handling bad debts, the **reserve** is reduced by charging against it specific bad debts which become worthless during the income year and is increased by crediting it with reasonable additions. What is reasonable will depend on the total amount of debts outstanding at the end of the year, including current debts, as well as those of prior years, and the

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total amount of the existing reserve. (Former Cal. Admin. Code, tit. 18, reg. 24348(g), (repealer filed Sept. 3, 1982; Register 82, No. 37).) The facts available in this case indicate that appellant's past loss experience related to personal property consumer loans which are of the type which tend to generate more bad debt losses than do real estate loans. After 1978, appellant's business essentially involved only real **estate loans**. Use, therefore, of past loss experience as the primary guide in determining a reasonable addition to a reserve would not be realistic or representative of appellant's current circumstances. Respondent determined that a \$60,000 reduction in the reserve was warranted to reflect the change in the type of receivables owed to appellant at the end of the income year. This determination was concurred in by the independent firm of auditors engaged by appellant to investigate its financial position. Appellant has not shown that respondent's actions were an abuse of discretion. The fact that another accounting firm has stated that it would have handled the reserve problem **differently** is not conclusive evidence of an abuse of discretion on the part of respondent. Likewise, the fact that the bad debt reserve was used up in later years does not in itself justify the additions made during the year in question. The former regulation specifically states that what constitutes a reasonable addition to a reserve is to be determined by the **facts** existing **at** the close of the income year. Thus, while an increase in loan delinquencies or defaults in **later years** might justify substantially greater additions to appellant's bad debt reserve in those years, such occurrences do not justify a reserve addition in an earlier year when the facts giving rise to them are still unknown.

Finally, appellant refers to the reserve account kept by Transamerica Financial Corporation as evidence that its own reserve was too low. We find this **analogy** unpersuasive as appellant has not shown that its business was similar to Transamerica's business or that Transamerica's reserve was reasonable.

For the reasons discussed **above**, we conclude that appellant has failed to establish that respondent abused its statutory discretion by reducing the claimed additions to appellant's bad debt reserve by \$60,000. Accordingly, respondent's action must be sustained.

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O R D E R

Pursuant to the views expressed in the opinion of the board on file in this proceeding, 'and good cause appearing therefor,

IT IS HEREBY ORDERED, ADJUDGED AND DECREED, pursuant to section 25667 of the Revenue and Taxation Code, that the action of the Franchise Tax Board on the protest of Bay Area Financial Corporation against a proposed assessment of additional franchise tax in the amount of \$5,400 for the income year ended June 30, 1979, be and the same is hereby sustained.

Done at Sacramento, California, this 5th day
of April , 1984, by the State Board of Equalization,
with Board Members Mr. Nevins, Mr. Dronenburg, Mr. Bennett
and Mr. Harvey present.

<u>Richard Nevins</u>	, Chairman
<u>William M. Bennett</u>	, Member
<u>Walter Harvey*</u>	, Member
<u></u>	, Member
<u></u>	, Member

*For Kenneth Cory, per Government Code section 7.9